Supreme Court, U.S.
FILED
JAN 3 1983
ALEXANDER L. STEVAS
CLERK

No. 82-868

In the Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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The questions raised by the petition in this income tax case are whether the Commissioner correctly required petitioner to accrue as income amounts due for goods shipped on a "sale or return" basis, and whether the Commissioner correctly disallowed a bad debt deduction claimed by petitioner for a debt which it claimed was partially worthless.

The pertinent facts may be summarized as follows: Petitioner is a corporation engaged primarily in the wholesale distribution of record and tape "cut-outs," i.e., records and tapes which manufacturers have been unable to sell at full price through normal distribution channels (Pet. App. A-11). Petitioner purchases large quantities of these cut-outs, breaks them down into lots suitable for shipment to a retail store, and ships them to its customers for sale at greatly discounted prices (Pet. App. A-11). Because these cut-outs are often unmarketable, even at a discount, petitioner offers its

customers the privilege of returning all unsold merchandise for full credit on their accounts. It has been petitioner's policy to permit any customer with a good credit standing to defer payment on each lot of merchandise until he returned the unsold merchandise from that lot, together with payment for the items sold (Pet. App. A-11).

Although petitioner encourages its customers to account for each lot and return any unsold merchandise within 120 days after shipment, customers often take longer than 120 days after shipment. In some cases, petitioner's merchandise is not accounted for until more than a year after shipment (Pet. App. A-11). Approximately 30 to 35% of the merchandise shipped by petitioner each year is not accounted for (by return or payment) until a later taxable year (Pet. App. A-4). Under petitioner's so-called "hybrid" method of accounting, it expensed each lot of merchandise by removing it from inventory at the time the lot was shipped, but did not record the corresponding sales income until a later time when the customer paid for the items he had sold and returned any unsold merchandise for credit (Pet. App. A-12). Thus, petitioner treated such transactions as sales for expense purposes, but not for income purposes. Had petitioner wished to treat the transaction as a consignment rather than a sale, the proper accounting would have left the cutouts in inventory even though they had been shipped to a retailer on consignment.

During 1974, one of petitioner's major customers, Sound On Tape Distributors, Inc. was enjoined from selling certain tapes (App. A-17). This cast significant doubt on the collectibility of some $176,000 that Sound On Tape owed petitioner. Nonetheless, Sound On Tape continued in business until 1978 and petitioner continued to do business with it until then, when the debt was settled for $5,000 (Pet. App. 17-18).

1. The decision below correctly sustained the Commissioner's exercise of his statutory authority under Section 446(b) of the Internal Revenue Code of 1954 (26 U.S.C.) to require petitioner to use the accrual method for computing its taxable income from sales of merchandise. Treasury Regulations, Section 1.446-1(c)(2)(i) (26 C.F.R.) expressly requires a taxpayer using inventories to compute its income from purchases and sales on the accrual method unless the Commissioner authorizes the use of some other method. Here, it is undisputed that petitioner is required to use an inventory in the computation of its taxable income, and that its use of the so-called "hybrid" method of accounting on which its tax returns were prepared was never authorized by the Commissioner (Pet. App. A-12, A-13). Therefore, petitioner cannot use its hybrid method of accounting for tax purposes, and the Commissioner properly required it to change to an authorized, i.e., accrual, method for reporting its taxable income.

Petitioner errs in its assertion (Pet. 10) that it was entitled to select a method of accounting and that its choice was binding on the Commissioner as long as it used its method for keeping its books. As this Court has held, the Commissioner has broad statutory authority to determine whether a taxpayer's method of accounting clearly reflects its income and to require any changes which he finds necessary to assure and protect the equitable collection of the revenue. *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959); *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 532, 542 (1979). In particular, petitioner may not, simply by adopting a method of accounting, limit the Commissioner's exercise of his discretion by requiring him to rebut a "presumption" in favor of the method chosen by the petitioner. *Thor Power Tool Co.* v. *Commissioner*, *supra*, 439 U.S. at 538-540. Thus, even on the assumption that petitioner had shown that its hybrid method of account-

ing conforms to generally accepted accounting principles (which it did not), such a showing would not have been sufficient to shift the burden to the Commissioner to show that it did not clearly reflect income before he could reject it for tax purposes. *Thor Power Tool Co.* v. *Commissioner*, *supra*, 439 U.S. at 538-544.

Wilkinson-Beane Inc. v. *Commissioner*, 420 F.2d 352, 355-356 (1st Cir. 1970), upon which petitioner relies (Pet. 6), does not conflict with the decision below. In that case, as here, the court of appeals affirmed the Tax Court's decision requiring a taxpayer using inventories to adopt an accrual method of accounting. Although the court in *Wilkinson-Beane, Inc.* noted in passing that the Tax Court had previously held that the cash method may clearly reflect income even though the taxpayer is required to use inventories in his business, the court held that, in order to prevail in such a case, the taxpayer must show that the results produced by his method of accounting are substantially identical to those reached by the Commissioner's method. *Id.* at 356. The hybrid method of accounting adopted by petitioner here clearly does not meet this standard (Pet. App. A-12).

2. Petitioner claims (Pet. 15-19) that it was entitled to deduct a portion of its receivable from Sound-On in 1974 as a partially worthless debt. A deduction for a partially worthless debt is allowable only when the Commissioner is satisfied that the debt is partially worthless. See Section 166(a)(2) of the 1954 code. Petitioner has failed to show that the Commissioner abused his discretion in disallowing the deduction in this case. *Brimberry* v. *Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979); *Sika Chemical Corp.* v. *Commissioner*, 64 T.C. 856, 862-863 (1975), aff'd, 538 F.2d 320 (3d Cir. 1976).

Petitioner asserts (Pet. 17) that the decision below conflicts with *Caldwell* v. *Commissioner*, 202 F.2d

112, 115 (2d Cir. 1953). However, in *Caldwell* the issue was whether the Commissioner could require a taxpayer (1) to change from the cash to the accrual method of accounting and (2) to include in its income for the year of the change certain prior period receivables which would otherwise escape taxation. The court held that since the items in question did not represent income properly accruable in the taxable year of the change, they could not be rendered taxable merely because of the change in the taxpayer's method of reporting income.[1] *Id.* at 115-116. This case presents no such problems with respect to the effect of the change on the proper tax treatment of the Sound-On receivable. Here the court of appeals found that petitioner simply failed to carry its factual burden of establishing partial worthlessness of the debt (Pet. App. A-19). That factual question does not warrant further review.

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

JANUARY 1983

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[1] The rule announced in *Caldwell* with respect to the omission of items of income resulting from a change in the taxpayer's method of accounting was legislatively overruled by the enactment of Section 481 as part of the Internal Revenue Code of 1954. For years after 1954, taxpayers are required to make appropriate adjustments in the year of a change in their method of accounting in order to prevent the duplication or omission of items solely because of the change.